

COLLEGE PLANNING

Overview

For the 2016/2017 school year, the average charge for tuition, fees, room and board at a four-year public university was \$20,090; for a private institution, it was \$45,370.² Families with multiple children in college at the same time may find this cost overwhelming to their financial situation and long-term security.

There are a couple of different strategies to save for college. The first is to save and invest in one account and hope you have enough to pay for everything — down payment for a house, college, retirement, etc. The second way is to choose separate vehicles specifically designed for each financial goal. The advantage to the latter strategy is that it avoids the temptation to “rob” from Peter’s college savings account to pay for Paul’s roofing catastrophe.

Moreover, investment and savings vehicles designed for specific goals typically offer additional advantages to help maximize contributions.

Expected Family Contribution (EFC)

College planning experts recommend that every student applies for financial aid no matter their family’s economic status. This requires completing the Free Application for Federal Student Aid (FAFSA). The form is used by the federal government and prospective colleges to assess a student’s need for financial aid. The information gathered is used to calculate the family’s overall ability to pay via the expected family contribution (EFC).

The calculation formula takes into consideration the student’s family size and number of dependent children enrolled in college in a given year, as well as a portion of the student’s and parents’ annual adjusted gross income and assets.³

- Parents: 0% to 47% of adjusted gross income, plus 0% to 5.6% of non-retirement assets
- Student: 50% of income over \$6,310, plus 20% of assets

It’s a good idea to start early and save continuously in an account specifically targeted for college funding. After all, time is the investor’s friend when it comes to the power of compounding interest. To get started, the following is a rundown of some of the most popular college saving options.

About 70 percent of college graduates leave school with more than \$30,000 in student loan debt.¹ While it’s great that so many more young people have the opportunity to get a college education, being saddled with that much debt is no way to start off adult life. For investors interested in saving for college so their children can avoid this situation, there are a number of viable options.



College Savings 529 Plans

A 529 plan is a qualified tuition program with two options:

1. The prepaid tuition plan enables parents to prepay the student's education (in a lump sum or over time) in today's dollars and protects against tuition increases.
2. The college savings plan invests contributions in a tax-deferred portfolio with an asset allocation matched to the beneficiary's age (automatically rebalanced to lower risk as the student gets closer to college age). Subsequent withdrawals are tax free when used to pay for the student's qualified education expenses at an eligible institution.

Target-Year Investing...

"An age-based strategy may really help people who don't want to actively manage their investments, because it maintains a mix of assets based on when the beneficiary is expected to start college and rolls down the risk as that time gets closer."⁴

- Keith Bernhardt, vice president of college planning at Fidelity Investments

Note that the college savings plan offers more flexibility than a prepaid plan but does not guarantee the investment will yield enough to pay the full tuition costs. Prepaid tuition plans are guaranteed to cover tuition for in-state public colleges only, but some states allow the beneficiary to use the funds at a private or out-of-state school.

Individual states offer 529 plans, and some even allow a portion of contributions to be tax deductible, but an investor can generally open an account in a different state than his or her residence. Investment options and account features vary, but all accounts permit high contribution limits and compound tax-deferred, and withdrawals for qualified college expenses are tax-free.

One of the advantages of a 529 savings plan is that it allows the owner (typically a parent or grandparent) to control the account on behalf of the child. The account owner may change the beneficiary to another member of the family and retain the assets if the student doesn't use the money for college. Notably, there is no time or age restriction for use of 529 funds, and the money may continue growing tax-deferred if the student delays college indefinitely.



Grandparents who open an account to help provide college funding for a family member have the advantage of retaining control of the assets, yet contributions are considered “completed gifts” for the purpose of estate taxes. Any funds not used for qualified college expenses are taxed at ordinary income rates.

Coverdell Education Savings Account (ESA)

A Coverdell account permits owners to make up to \$2,000 a year in nondeductible contributions, but the investment grows tax free. Like 529 plans, the owner can change the beneficiary to another family member, but any funds that remain in the account after the beneficiary turns age 30 will be subject to penalties. However, Coverdell assets can be used for a child’s educational expenses from grade school to graduate school.⁵

IRAs

Investors who prefer to consolidate their investments may consider using an IRA to save for college. Money may be withdrawn to pay for qualified higher education expenses (for the account owner, spouse or child) at any age without being subject to the 10 percent early withdrawal penalty. However, annual contributions are limited to \$5,500; \$6,500 if age 50 or over (2017), and distributions from a traditional IRA are taxed as ordinary income.⁶

If the investor uses a Roth IRA for college savings, all contributions are post-tax and money held for at least five years may be withdrawn tax free.

Investors who use an IRA for college savings generally have more investment options available, and any unused money may continue to grow tax-deferred for retirement.

Investment Portfolio

If parents save for college with a taxable portfolio, they may have plenty of investment options available, but the money does not benefit from tax-deferred compounding. When assets are withdrawn to pay for college expenses, gains are taxed at the parent’s income rate.

Custodial Accounts

Another option is to establish a “custodial” account for a minor, such as an UGMA or UTMA. All funds contributed are considered irrevocable gifts and transfer to the child’s control once he or she becomes the age of majority in that state. In most cases, when the money is withdrawn, the investment gains are taxed at the child’s income tax rate, which is usually



lower than the parent's rate. However, once the child comes of age, the parent no longer has control over the account, so the money may not be used as intended for higher education.

Impact on Financial Aid

When deciding which college savings account to choose, consider how it will impact the student's eligibility for financial aid. Consider:⁷

- Taxable investment portfolios hold a greater factor in reducing potential aid than tax-deferred accounts.
- Because a 529 college savings plan is considered a parental asset, it is factored into federal financial aid formulas at a lower rate (5.6%).
- A custodial account, on the other hand, is considered the student's asset, and up to 20% may be factored into the calculation, which is more likely to reduce the financial aid package.
- When a grandparent (or someone other than the student or parent) owns the 529 plan, its funds are not factored in as a student asset until distributed. This means, however, that a prior year withdrawal will count toward the student's income on the next year's FAFSA form — potentially lowering the subsequent aid package.

Final Thoughts

When parents and grandparents first gaze upon a newborn, or attend dance recitals, soccer games and birthday parties, they really don't know whether that child will turn into a scholar or an athlete or a hard worker or an average student by the time he or she graduates from high school. But none of that really matters. If you want your student to attend college, and you want to help him or her pay for it, it's important to start saving as early as possible. Choose the appropriate plan or account for your circumstances, and keep investing. The following tips might help:

- Set up automatic withdrawals, even if you start with just \$25 or \$50 a month.
- Increase the amount of monthly contributions each year.
- Take advantage of employer programs that offer automatic payroll deductions into a 529 plan.
- Pay attention to sales charges and ongoing management and investment fees so that expenses don't substantially reduce returns.
- Add to the account whenever you receive a financial windfall.
- Ask friends and family to contribute to the account as birthday and holiday gifts.



- ¹ The Institute for College Access & Success. 2016. "State by State Data." <http://ticas.org/posd/map-state-data>. Accessed July 12, 2017.
- ² Fidelity. April 20, 2017. "The ABC's of 529 college savings plans." <https://www.fidelity.com/viewpoints/abcs-of-college-savings-plans>. Accessed July 8, 2017.
- ³ Fidelity. 2017. "Financial Aid Planning." <https://www.fidelity.com/life-events/saving-for-college/financial-aid-planning>. Accessed July 8, 2017.
- ⁴ Fidelity. April 20, 2017. "The ABC's of 529 college savings plans." <https://www.fidelity.com/viewpoints/abcs-of-college-savings-plans>. Accessed July 8, 2017.
- ⁵ Ibid.
- ⁶ IRS. 2016. "Education Exception to Additional Tax on Early IRA Distributions" <https://www.irs.gov/publications/p970/ch09.html>. Accessed July 12, 2017.
- ⁷ Fidelity. April 20, 2017. "The ABC's of 529 college savings plans." <https://www.fidelity.com/viewpoints/abcs-of-college-savings-plans>. Accessed July 8, 2017.

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